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GEORGIA'S CORPORATE TAXES : SHOLD THE CORPORATE INCOME TAX BE REPEALED

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GEORGIA'S CORPORATE TAXES: SHOULD THE CORPORATE INCOME TAX BE REPEALED?

Georgia like most of her sister states has a corporate income tax. The corporation income tax was first introduced in Georgia in 1929. The rate has always been a flat proportional rate, fluctuating up and down during the years within the range of 4 percent and 7.5 percent. The present rate of 6 percent has not changed since 1969. The corporation franchise tax, levied on net worth, is administered in conjunction with the corporation income tax. In 1997 these two taxes constituted approximately 6.91 percent of the state's tax revenues. However, this percentage fluctuates from year to year and has decreased over the past number of years. In 1997, corporations paid \$ 729.5 million in these two taxes, of which \$706.9 came from the income tax and \$22 .5 million came from the net worth tax.¹

Why Tax Corporations?

Before discussing the company tax situation in Georgia, it is also important to understand the rationales behind the general taxation of business.² The first is to mask the cost of government. This is a strong motive for the use of the tax and is often seen as an advantage of taxing businesses. Voters may believe that taxing business is a good idea as it reduces the individual citizen's tax liability. Furthermore, voters may not understand that business taxes are shifted to taxpayers, e.g., in the form of higher prices.

A second reason for taxing business is based on the notion of ability to pay. It is commonly believed that corporations are the proper subject of taxation because of their size and control of resources. Thus, corporations appear to have a superior ability to bear the burden of taxation. This argument is commonly employed to make the tax system more equitable. Those with greater ability to pay should pay higher amounts of their income.

A progressive tax structure that may make sense on equity grounds for individuals does not make sense for corporations. The reason for this difference is that businesses are not the ultimate taxpayers. Corporations are merely a set of contractual relations between capital owners, other resource

¹ State of Georgia, Department of Revenue, *Budget Report*, 1997. (Total differs due to rounding.)

²This section relies upon William Oakland, "Business Taxation in Louisiana: An Appraisal," in *Louisiana's Fiscal Alternatives* ed. by J. A. Richardson (LSU Press: Baton Rouge) 1988: 159-187.

owners, and the customers of the corporation. Taxes placed on business eventually flow through to people. Thus, a higher tax on a more profitable firm may not necessarily be borne by more wealthy individuals. For example, a tax on a corporation providing a public service such as electricity, which can be a large and profitable enterprise, can be passed on to capital owners, employers, and consumers. One can not guarantee that all owners of capital are wealthy individuals as many lower or middle income individuals may have invested in the corporation for retirement purposes.

Employees can also be displaced or have wages lowered by higher business taxes. Thus, employees can bear some of the burden of the tax. Further, customers may pay higher prices as the result of the tax. Lower income customers pay a larger percentage of their income on necessities such as electricity and to the extent that a higher profit tax is passed along to the consumers, the higher profits tax on a large profitable company (which appears to be progressive) has a regressive effect because of the relatively larger percentage of income that goes to paying the electric bill by the relatively poorer consumer.

Another rationale for taxing business concerns the attempt by states to export the tax bill to taxpayers outside the state. Many firms sell products in a number of states. If a tax causes firms to raise prices, non-residents can end up paying a portion of the state's tax bill. Similarly, if a state taxes large publicly held corporations, the owners are spread throughout the nation. To the extent the tax is paid by capital owners, it is then paid by many outside the state. This can be a popular justification for taxing business, as state residents can enjoy a higher level of public expenditure as the expenditure is supported by out-of-state tax payers.

There are problems with this rationale that can significantly affect the local industrial base of the state. Suppose, for example, we have two states, one with a tax on business and one without. Suppose the company in the state with the tax on business tries to sell to customers in the state that does not tax business. Suppose further that his company tries to "export" the tax and pass along the tax in terms of higher prices. The firm will be able to pass along the tax if, and only if, it has monopoly power. As long as the other state's markets are competitive, the firm will not be able to pass along the tax to consumers in other states. Thus, in an attempt to raise prices and pass along the tax, the firm could lose market share, as the firm's competitors in other states are not subject to the tax. Attempting to export taxes through the business tax can make a state's own industry less competitive in relation to other states.

Further, if the company can not pass along the tax to out of state consumers, it must pass it along to other capital owners, employees, or consumers in its home state. This reduces the profitability of the state's industry, the state's employment opportunities, as well potentially increasing the prices paid by consumers.

Finally, the most persuasive rationale for the taxation of business is the cost of services rendered by the state to the firm. This rationale is based on the premise that government often provides services to firms and that it is appropriate for the user of these services to pay for the services. This argument has an appeal on the basis of both equity and efficiency. Those that benefit from the corporation's use of state resources should compensate the state for these services. Capital owners benefit from the state provision of services, as do the employees of the business and its customers. In addition, prices paid by customers will thus reflect the true costs of providing services.

The motive for this type of business taxation is known as the *benefit principle*. However, the implementation of the benefit principle is very difficult. Benefits received by the corporation from the provision of state services and goods are difficult to measure. In addition, it is difficult to determine the appropriate services business should be charged. For example, society benefits from an educated population. Business also benefits as a better-educated workforce is more productive. It is tempting to tax business for educational services provided to them in the form of higher educated workers. However, a higher educated worker will likely receive higher wages. To tax businesses for educational services will, in effect, double charge business for education. Thus, it is important to charge business for those goods and services provided directly to it rather than for services rendered to employees or other inputs it uses in production of goods and services.

From the four rationales provided for the taxation of business it is important to understand that corporations are not the ultimate taxpayer. Rather, shareholders, employers and consumers are the true taxpayers. This is an important concern that should be kept in mind for the remainder of the report.

A Look at Georgia's Corporate Taxes over Time

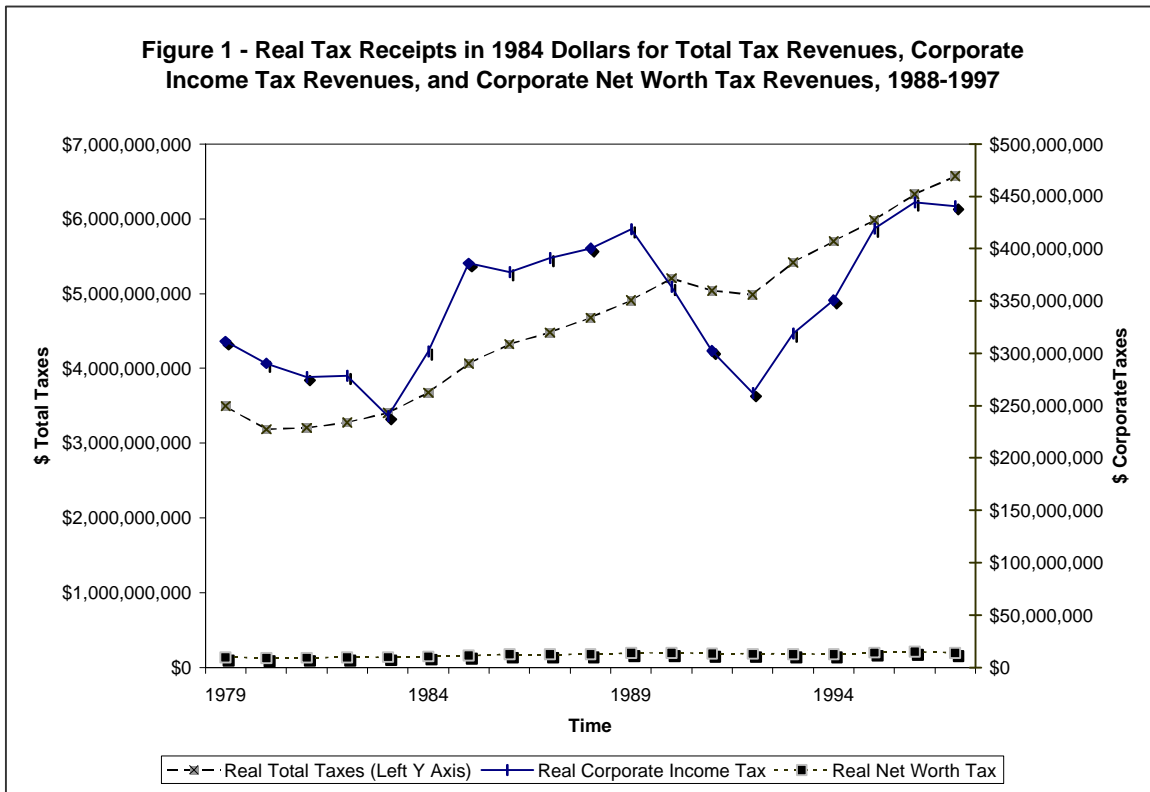
Figure 1 shows the two components of the corporate tax. The left axis shows the real (i.e., inflation adjusted) total tax revenue over the last decade while the right axis shows the real corporate income tax and net worth tax revenues. Over this time frame total taxes have increased steadily, while

the corporate income tax has shown some volatility. The net worth tax, however, has remained flat over the entire period.³

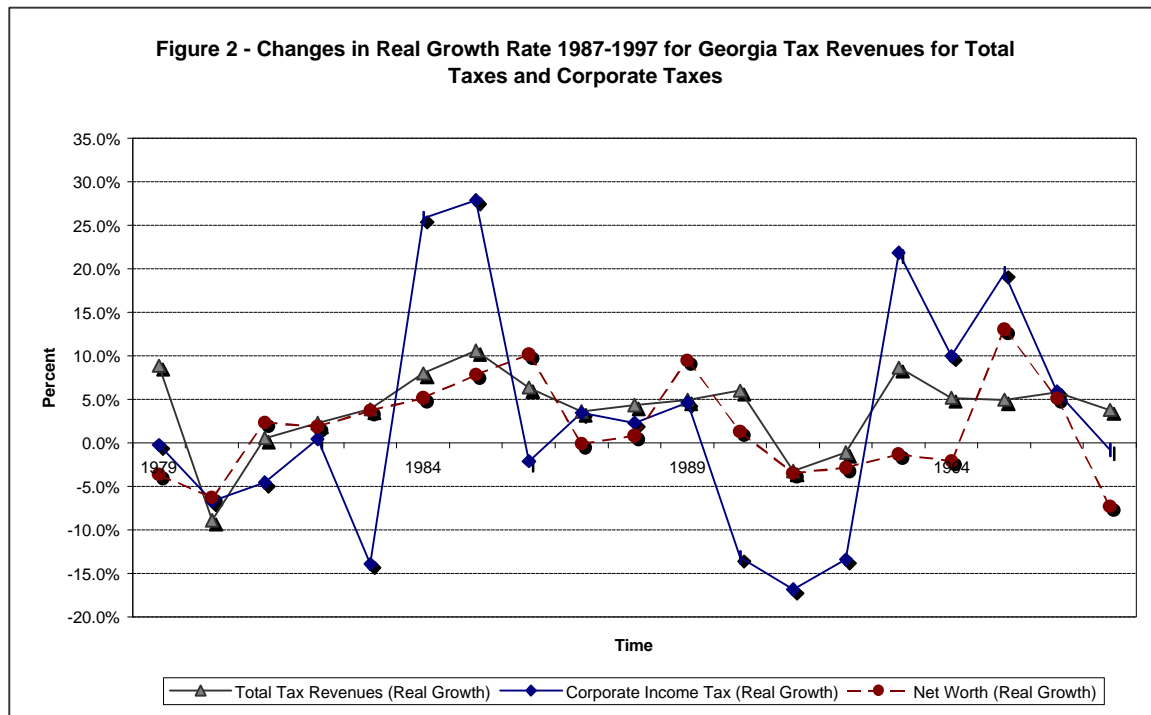
The most important reason for this volatile performance is that since the tax falls on profits, the corporation tax is very sensitive to fluctuations in the economic business cycle; much more so than is the case for the individual income tax, the sales tax or the property tax. Figure 2 shows that real corporate income tax revenues are very cyclical, corresponding to changes in the business cycle. As shown in Figure 2 the growth rate in corporation tax revenues after adjusting for inflation is on average 1.97 percent, while the growth rate for all taxes after adjusting for inflation was 3.95 percent. This growth rate turned sharply negative from 1989 to 1992 then increased sharply in 1993. Since 1997 the growth rate has again turned negative. The more volatile nature of corporate income taxes vis-a-vis other revenues is also illustrated in Figure 2 where the rate of growth of corporate income taxes is compared to that of Georgia's total revenues.

Over time the corporate income tax as a percentage of total tax revenues has fallen (Figure 3). As can be seen, the rate has fallen over the period from about 10 percent in 1979 to approximately 7 percent in 1997. Georgia is in line with other states in this regard. Figure 4 shows Georgia's percentage of corporate income tax (CIT) to total tax revenues over time and corporation income tax as a percentage of total tax revenues for the entire U.S. In addition to showing the general downward trend in corporate tax collections nationally, we see that Georgia is also more volatile than the national average rate.

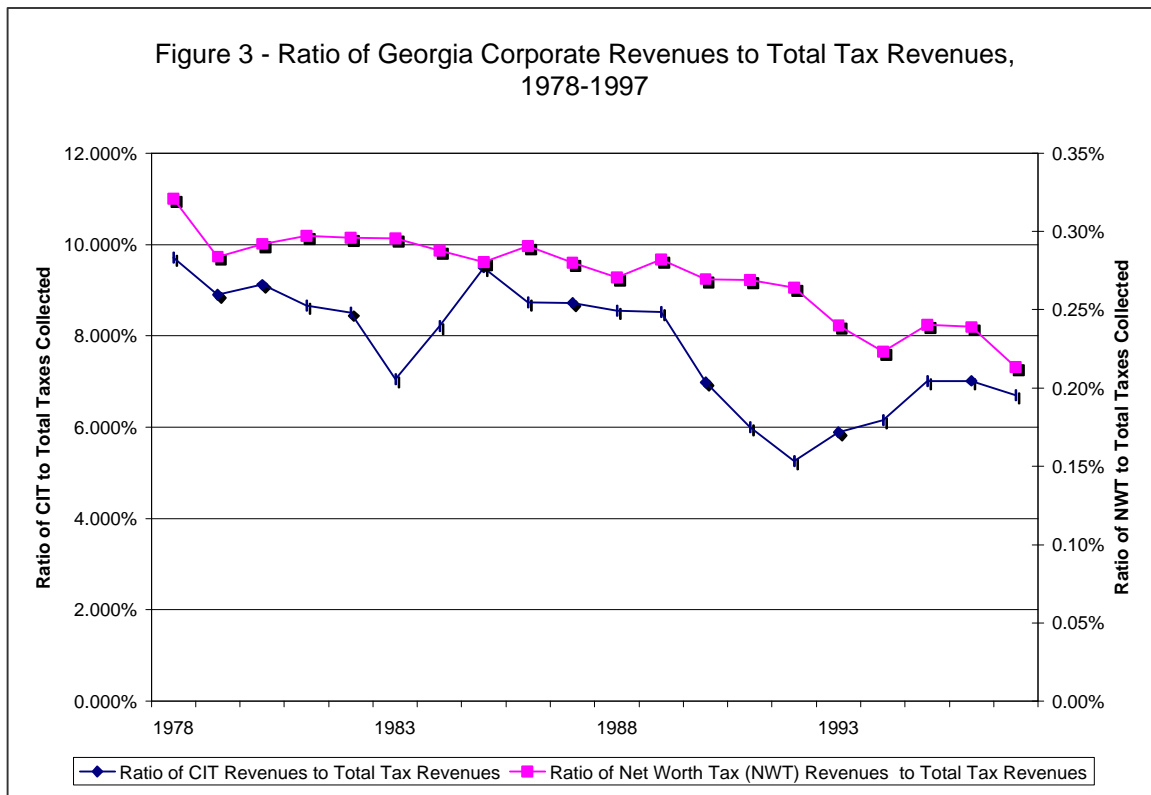
³ Since this tax in real terms is small, I do not discuss it in great detail.



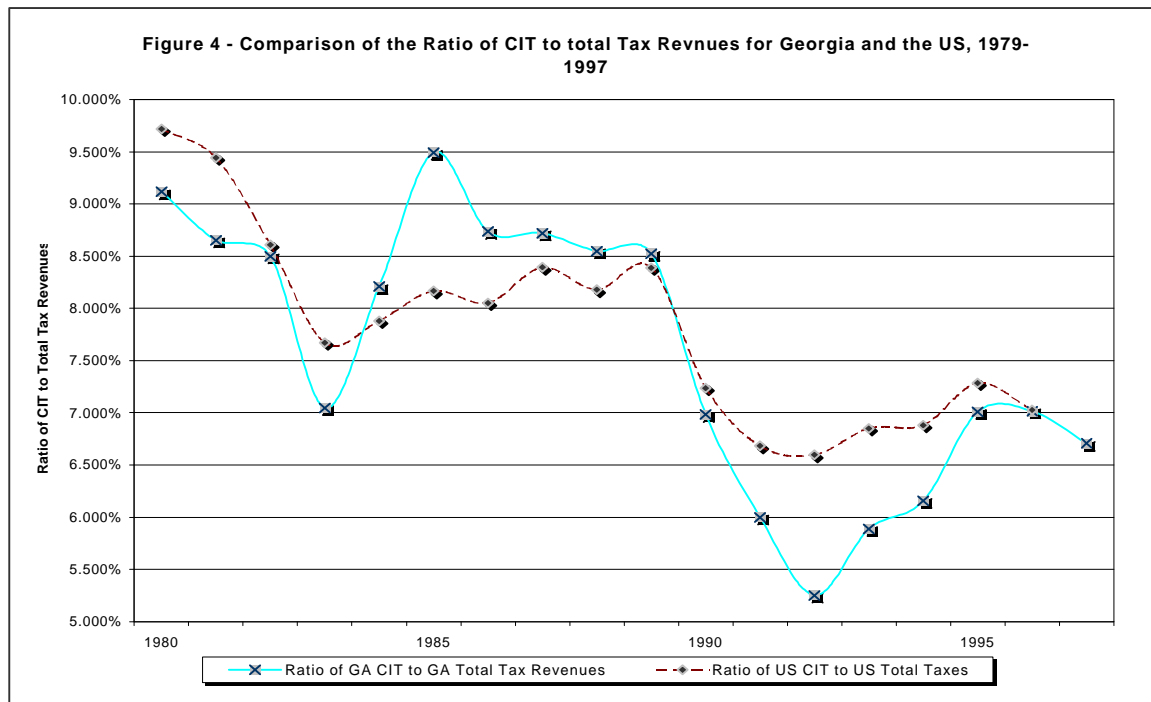
Source: Georgia Department of Revenue, *Statistical Report* (various years), (1983-1984 = 100)



Source: Georgia Department of Revenue, *Statistical Report* (various years)



Source: Georgia Department of Revenue, *Statistical Report* (various years)



Source: Georgia Department of Revenue, *Statistical Report* (various years) and U.S. Bureau of the Census, *State Government Finances*, (various years).

Georgia's Tax Structure

The CIT rate is a flat 6 percent and it is imposed on Georgia taxable net income. To arrive at Georgia taxable net income, first federal taxable income is adjusted by adding income exempt at the federal level and deductions disallowed by Georgia and by subtracting interest on the obligations of the U.S. This net business income is then allocated or apportioned according to the property owned or the business done in Georgia. Any credits allowable are then deducted against the net allocated income to Georgia.

The apportionment of a multi-state company's profits to Georgia is currently based on a three-factor formula with a double weight on sales. Traditionally, Georgia used a three factor formula of sales in Georgia as a percentage of sales in the United states plus employment in Georgia as a percentage of employment in the US plus property in Georgia as a percentage of property throughout the United States. This formula gave equal weight to the fraction of sales in the state as to the fraction of property or employment in Georgia. In 1995 the legislature amended the formula so that sales was weighted 50 percent and property and employment was each weighted 25 percent. The overriding consideration for the adoption of modified formulas, i.e., giving more weight to the sales factor, is to encourage the location of businesses in the state. The heavier weight given to sales in the modified formula decreases the tax burden of companies with property and payroll in the state while it increases the tax burden for out-of-state companies that mostly just sell commodities within the state.

Economists believe the corporate income tax to be a tax on capital. To the extent that Georgia's tax burden on capital is greater than other jurisdictions, then a portion of the burden falls on capital invested in Georgia. Further, due to the make-up of firms in the state, some may bear more of the burden of taxation than other firms. Others bear a higher burden because they are more profitable or they are from out of state.

Georgia Compared to Sister (Neighbor States)

Table 1 shows a simple comparison of Georgia's tax rates with other states in the south. Alabama, Florida, South Carolina, and Texas each have a flat rate less than Georgia's while Mississippi's highest rate is less than Georgia's. Arkansas' highest rate is slightly above Georgia's but its lucky and Louisiana have bracket rates above Georgia's, but the lowest bracket is a full two-percent below Georgia's. Finally, North Carolina is the only state with a rate uniformly above Georgia's rate while Tennessee and Virginia share Georgia's six-percent flat rate. Thus, Georgia's rate is among the higher tax rates in the south.

Table 2 shows the ratio of corporate income tax revenues to gross state product. One can think of this as how much of the state's total product goes to pay for the corporate income tax. Georgia is below the national average and among southern states is about in the middle. Neighbor states South Carolina and Alabama have lower ratios while Florida's rate is slightly higher.

Incidence by Economic Sector

For 1991 (the most recent year this data are available) over two-thirds of the tax was paid by manufacturing firms (33.1 percent), utilities and transportation (21.1 percent) and wholesale and retail (15.2 percent). This is most likely to be the result of the mix of corporations in the state. As the state becomes less dependant upon manufacturing and more dependant upon new industries, the mix is likely to change.

By Income Category

Even though the Georgia Corporate Income Tax (CIT) rate is a flat rate of 6 percent of taxable income, there is some progression built into the system as the more profitable companies pay a much larger percentage of the total CIT. In 1995, those companies with net taxable income over \$1,000,000 paid 75.77 percent of all corporate income taxes in Georgia. Those with taxable income between \$500,000 and \$ 1 million paid 7.28 percent of all taxes and those with income between \$100,000 and \$500,000 paid 10.16 percent. Thus, those companies with net taxable income above \$100,000 paid 93.21

Table 1 Tax Rates and Brackets for Southeastern States, 1998

State	Tax Rates %	Tax Brackets		# of Brackets
ALABAMA	5	---Flat Rate---		1
ARKANSAS	1.0 - 6.5	3,000	100,000	6
FLORIDA	5.5	---Flat Rate---		1
GEORGIA	6	---Flat Rate---		1
KENTUCKY	4.0 - 8.25	25,000	250,000	5
LOUISIANA	4.0 - 8.0	25,000	200,000	5
MISSISSIPPI	3.0 - 5.0	5,000	10,000	3
NORTH CAROLINA	7.25	---Flat Rate---		1
SOUTH CAROLINA	5	---Flat Rate---		1
TENNESSEE	6	---Flat Rate---		1
VIRGINIA	6	---Flat Rate---		1
TEXAS	no tax			

Source: Federation of Tax Administrators internet site, <http://www.taxadmin.org>.

Table 2 Ratio of Corporate Income Tax Revenues to Gross State Product, 1996

State	Ratio of CIT to GSP	Rank in SE
Alabama	0.246%	4
Arkansas	0.364%	11
Florida	0.299%	7
Georgia	0.285%	6
Kentucky	0.300%	8
Louisiana	0.217%	3
Mississippi	0.332%	9
North Carolina	0.406%	12
South Carolina	0.274%	5
Tennessee	0.333%	10
Texas	0.000%	1
Virginia	0.173%	2
US Average	0.385%	

Source: Bureau of the Census, internet cite <http://www.census.doc>

percent of all corporate income taxes. However, this group of taxpayers accounted for only 4.04 percent of corporate filers.⁴

By Foreign vs. Domestic Companies

A benefit of the corporate income tax mentioned above is that it was possible to export “tax payments” to out-of-state taxpayers. In 1995 over 52 percent of the corporate income tax revenue came from foreign (out-of-state) corporations. This group's tax liabilities were paid by only 16.2 percent of all corporate filers. The problem to note here is that foreign taxpayers are likely to be relatively large companies that have investors in many states, including Georgia.

Consequences to the State of Georgia from Eliminating the Corporate Tax

Loss of Revenues

There are a number of consequences of removing the corporate income tax and the net worth tax. The major negative consequence is loss of revenue. In 1997, the corporate income tax was the third most important tax in the state in terms of total revenues, accounting for approximately 7 percent of state revenues. The two most important taxes are the individual income tax (42.64 %) and the sales and use tax (39.1%). If the CIT is removed, the state will either cut its budget by the amount of the revenue shortfall (about \$700 million), increase other taxes (about \$700 million) or a combination of the two. It will likely be difficult to increase other taxes. The legislature in 1998 decreased the effective income tax burden for individual income tax payers by increasing the personal and dependant exemptions. (This tax cut was about \$205 million) In 1996, the state began a phase out of the sales tax on food, for home consumption (estimated tax cut of \$466 million).

A 1994 study of the effect of removal of the corporate income tax estimated that the 1991 CIT collections, then at \$416 million could be replaced by an increase in the sales tax by 0.6 percent or by an increase in the top personal income tax bracket from 6.0 to 7.0 percent.⁵ Both of these estimates appear to be close approximations using 1997 data.

⁴ Georgia Department of Revenue, *1997 Statistical Report*.

⁵ Martin F. Grace and Jorge Martinez-Vazquez *Georgia's Company Taxes: A Report to the Joint Revenue Study Commission*, 1994.

Leaky Tax

The CIT “leaks”, that is, the amount of profits able to be taxed by the state diminishes over time. Although total CIT revenue appears to be increasing, it is not clear how much is being legally avoided. This leaky-ness is due to the way Georgia allows companies to file their taxes. Georgia uses separate income accounting -- the detailed allocation of receipts and expenditures to each separate legal entity -- to determine the portion of the business that a corporation does in the state. Thus, if there are two related corporations doing business within and outside the state, the Georgia statute allows each of the legal entities to report their separate accounts and profits.⁶

The main difficulty with separate accounting reporting is that it permits corporations to employ strategies to reduce the state tax liability in an artificial and, potentially, inequitable way. Under separate income accounting corporations have a strong incentive (and are allowed) to shift profits to those states that will tax profits more lightly or that do not tax them at all. The shifting of profits across state lines is easily accomplished by using internal transfer pricing arrangements or by establishing shell passive income companies in states, such as Delaware, that exempt this type of income. The shell company is established by, for example, giving it the intellectual property rights to the name of the parent company at the same time the parent company leases the right to use the name. Thus, a company that does substantial business in Georgia can set up a Delaware holding company. The Georgia company gives the holding company its trademarks, service marks and the rights to its name. Then the Georgia company leases the right to use the name from the holding company. The lease payments could amount to a substantial fraction of the firm’s Georgia profits.⁷

Recently, the legislature enacted a law that would give the Commissioner of Revenue authority to alter a potential taxpayer’s allocation method if it would attract that potential taxpayer to move to Georgia.⁸ This future leak in the system will reduce the growth of the corporate income tax base over time. A further source of leaks already implemented comes as a result from credits allowed in the tax

⁶ OCGA ' 48-7-34.

⁷ *Arron Rents, Inc. v. Collins*, Fulton Superior Court, June 22, 1994, appeal denied Georgia Supreme Court August 24, 1994.

⁸ Act 503 (HB 1353) Laws of 1998 effective 2/12/98.

code. In addition to credits for water conservation⁹, the tax code also allows credits for investment in certain less developed parts of the state¹⁰ and for retraining programs.¹¹ The reduction in corporate taxes for 1995 resulting from the three largest credits were:

Job Tax Credit	\$7.85 million
Basic Skills Training Credit	\$5.44 million
Investment Tax Credit	\$8.40 million (average of 1995 and 1996)

The other credits are miniscule.¹²

Competitive Advantage viz. a viz. Other States

Georgia's CIT, if removed, could also provide an incentive to attract new firms to Georgia. Low or no corporate taxes would give Georgia a comparative advantage over neighbor states in attracting new firms to invest in the state. Economists, however, generally have been unsuccessful in finding an empirical connection between the level of state taxes and the decision to leave or enter a state.¹³ Firms have a number of decision making criteria, such as public infrastructure, land prices, wage rates, schools, as well as regulatory and tax treatment. Thus, taxes are not a major factor, but it is incorrect to suggest that they do not matter at all, and the more the other factors do not differ across locations, the more important taxes are to the choice location.

The reduction of the state income tax would also be viewed as a competitive move by neighbor states. This type of competition is arguably better for the Georgia than piecemeal deals to attract a new auto manufacturer, for example, or credits for investments in needy parts of the state. This is because *all* potential entrants are given the incentive to invest in Georgia and there is no incentive (or ability) for the state to give away the "store" to any one investor by forgoing significant tax revenues in the future.

⁹ OCGA ' 48-7-40.10 and ' 48-7-40.11.

¹⁰ OCGA ' 48-7-40.1.

¹¹ OCGA ' 48-7-40.5.

¹² Anthony Jackson, Department of Revenue.

¹³ See Keith Ihlanfeldt, *Tax Incentives for Economic Development in the State of Georgia*, Joint Study Commission on Revenue Structure, Staff Paper No. 2, Policy Research Center, Georgia State University. 1994.

Summary and Conclusion

None of the rationales behind the use of business taxes to raise general revenues are persuasive. Corporate income taxes may be invisible to the state's taxpayers, but they are paid to a great extent by capital owners, employees, other resource owners, and consumers. Although, currently about 7 percent of state tax revenues, the Georgia corporate income tax is a relatively volatile source of income to the state and has decreased in importance over time. It is also a "leaky" tax because it is subject to legal tax avoidance strategies that are difficult to plug. This and other changes in the law will likely make the state's tax collections from corporate income even smaller.

An outright repeal of the tax would reduce state revenues. This could cause the state to attempt to raise other taxes to keep revenues unchanged. A repeal of this sort might be difficult given recent reductions in those taxes most likely to be able to make up the difference such as the personal income tax and the sales and use tax. However, it may be possible to phase out the corporate tax over a number of years without increasing the burden on the sales or personal income tax. This can be accomplished if the other tax bases continue to grow. Furthermore, the reduction of the corporate income tax may increase jobs and consumption in Georgia, thus increasing tax revenue to make up for part of the loss of corporate tax revenues.

A reduction in the CIT or its eventual repeal would enhance Georgia's competitive advantage for attracting new business. A repeal would make Georgia and Texas the only states in the south without a CIT. A corporate income tax repeal, by itself, is not enough to attract investment as business examine more than just the corporate tax climate when making decisions to relocate. However, combined with Georgia's physical and educational infrastructure improvements, the repeal of the corporate income tax will provide new investors a strong incentive to invest in Georgia.

About the Author

Martin F. Grace received his Ph.D. in economics and his J.D. from the University of Florida in 1986. He is a Senior Research Associate at the Policy Research Center and is currently the Associate Director of the Center for Risk Management and Insurance Research. Professor Grace served on the staff of the Georgia Joint Study Commission on Revenue Structure and on the staff of the Commission to Study the Taxation and Economic Development for Ohio. His research interests include state taxation and regulation of the insurance industry. He is currently Associate Professor of Risk Management and Insurance and Associate Professor of Legal Studies in the Department of Risk Management and Insurance. He has published in insurance and economics journals and is currently an associate Editor of the *Journal of Risk and Insurance* and President of the *Risk Theory Society*.